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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 413

GULF, MOBILE & NORTHERN RAILROAD CO., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE RESPONDENT [redacted]

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 51) is reported in 22 B. T. A. 233. The opinion of the Court of Appeals (R. 128) is reported in 71 F. (2d) 953.

JURISDICTION

The judgment of the Court of Appeals was entered on May 14, 1934 (R. 135), and was modified on June 25, 1934 (R. 135–136). The petition for

certiorari was filed on September 25, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Where the Government took over the railroad of the taxpayer under the Federal Control Act and at the end of Federal control returned the property to the taxpayer, whether the taxpayer realized taxable income in the amount of $50,561.95 as the result of the Director General allowing its claim on account of a shortage of materials and supplies, within the meaning of Article 49 of Treasury Regulations 45.

2. Where several corporations file a consolidated return and the bonds of one of the subsidiaries, which were originally issued at a discount, are held during the taxable year by the parent company, whether the amortization and deduction of bond discount by the subsidiary is an intercompany transaction during the taxable years under Articles 636 and 635 of Treasury Regulations 65 and 69, respectively, and should be eliminated.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 10–12.

STATEMENT

The facts as found by the Board of Tax Appeals and relating to the issues involved in this petition (R. 56, 58, 61) may be summarized as follows:

The properties of the Gulf, Mobile & Northern were taken over by the President and were operated by the Director General of Railroads throughout the period January 1, 1918, to February 29, 1920. Among the assets and properties taken over by the Director General was an inventory of materials and supplies which had cost the taxpayer $286,664.26. At the conclusion of Federal control the Director General turned back to the taxpayer an inventory of materials and supplies of the market value of $275,912.03. The inventory so turned back included a greater quantity of some materials and a lesser quantity of other materials than were included in the inventory taken over by that official. Much of the materials in the inventory turned back by the Director General was, as to quality and relative usefulness, inferior to the material turned over to that official at the beginning of Federal control. (R. 58.)

In 1920 the Gulf, Mobile & Northern and the Director General effected a final settlement of all claims arising out of Federal control and operation of the former's properties, as a result of which the taxpayer paid to the Director General the sum of $100,000. One of the claims asserted by the taxpayer, and allowed by the Director General, was

for shortages in, and differences in grade and quality of, materials and supplies turned back by the Director General, in comparison with the materials and supplies turned over to that official at the beginning of Federal control, and amounted to $61,314.18. Thus the taxpayer received from the Director General, in 1920, cash and materials and supplies of an aggregate value of $337,226.21, which exceeded the cost of the inventory turned over to the Director General by $50,561.95. The Commissioner held that such excess is income for 1920, and accordingly added $50,561.95 to income for that year. (R. 58.) The Board of Tax Appeals decided that there was a completed transaction in 1920, and, in the absence of evidence as to the actual gain, upheld the Commissioner's determination that the gain was $50,561.95. (R. 84.) The Court of Appeals affirmed the decision of the Board on this point. (R. 133.)

At various dates between 1913 and 1916 the Meridian & Memphis sold its 30-year 5-percent gold bonds, of a total face value of $675,000, to the Equitable Loan & Mortgage Company of Mobile, at a discount of approximately $131,000. At the time the Gulf, Mobile & Northern acquired the capital stock of the Meridian & Memphis, the bonds of the latter were pledged as collateral for certain collateral trust notes of the Equitable Loan & Mortgage Company. These notes fell due during the period of Federal control and were taken up by the

War Finance Corporation. At the end of Federal control the Gulf, Mobile & Northern settled with the War Finance Corporation for the notes and took over the bonds pledged as collateral thereto at a cost of $636,000. Each year the Meridian & Memphis has charged off on its books 1/30th of the discount on its bonds, and in its returns for 1924, 1925, and 1926 claimed deductions for amortization of bond discount, each in the amount of $4,585.32. These deductions were disallowed by the Commissioner in determining consolidated net income. (R. 61.) The Board of Tax Appeals upheld the Commissioner's action (R. 88), and the Court of Appeals affirmed the decision of the Board on that point (R. 134).

ARGUMENT

In regard to the question whether the taxpayer realized taxable income as the result of the inventory adjustment in the final settlement with the Director General, Article 49 of Treasury Regulations 45 (1920 ed.), *infra*, p. 11, provides that where the owner of property has transferred title by reason of the exercise of the power of eminent domain, and has received compensation in excess of the cost, the transaction will be deemed to be completed, unless the taxpayer elects to replace or restore the property. In other words, the regulations treat a transaction under such circumstances as analogous to a sale, so that the excess over cost is subject to tax. This provision has been included in every

series of Treasury Regulations from 1918 until 1933.[1] Section 213 of the Revenue Act of 1918, in explanation of which Article 49 of Treasury Regulations 45 was promulgated, was reenacted without material change in the Revenue Act of 1921. The reenactment of the statutory provision without material change must be deemed to constitute legislative approval of the administrative construction. *Brewster* v. *Gage,* 280 U. S. 327, 337; *Burnet* v. *Brooks* 288 U. S. 378, 392–393.

As a matter of fact, the provision of the regulations was expressly written into the Revenue Acts of 1924, 1926, 1928, and 1932. See Section 203 (b) (5) of the Revenue Acts of 1924 and 1926, and Section 112 (f) of the Revenue Acts of 1928 and 1932.

The Circuit Court of Appeals for the Second Circuit upheld the regulations in question in *Lehigh & Hudson River Ry. Co.* v. *Commissioner,* 36 F. (2d) 719, certiorari denied, 281 U. S. 748. In that case, which involved similar circumstances, the court said (p. 720):

> Such a transaction is equivalent for tax purposes to a sale of the supplies at the agreed price. The act of 1918 (40 Stat. 1057) did not, indeed, expressly provide for gains arising from the requisition of property, but article 49 of the Regulations did:

[1] Treasury Regulations 62, Article 49; Treasury Regulations 65, Article 1579; Treasury Regulations 69, Article 1579; Treasury Regulations 74, Article 579; Treasury Regulations 77, Article 579.

> "When the owner of property has lost or transferred title by reason of requisition or eminent domain * * * if the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the income shall be measured by the excess of the amount of the compensation over the cost of the property." This article and article 50 prescribed the formalities by which the election should be manifested, with none of which the railway conformed.

The taxpayer contends that the decision of the lower court is in conflict with the principle laid down in the *Lehigh & Hudson River Ry.* case. (Br. 4–5.) On the contrary, both the lower court and the Board of Tax Appeals cited that decision with approval. The taxpayer also contends that the question is important in revenue taxation affecting a great many railroads whose tax cases have not yet been settled. (Br. 5.) We have been advised by the Treasury Department that the question of inventory adjustment of materials and supplies is involved in very few, if [redacted], cases that are still open. The taxpayer also argues that if there was any gain on the inventory adjustment of materials and supplies it should have been $9,000 instead of $50,000. (Br. 16.) If the taxpayer had conformed to the provisions of Article 50 of Treasury Regulations 45, it might have reduced the gain for the year 1920. In such a case, however, the taxpayer's

income for the years following 1920 when these materials and supplies were used would have been increased in the amount of the balance, or $41,000, by having the deduction for business expenses decreased in a corresponding amount. Since those years are no longer open, the taxpayer is estopped to say that the profit in the year 1920 should be limited in such a manner.

With respect to the right of the taxpayer to amortize and deduct the discount on bonds issued by an affiliated company but now held by the taxpayer, this Court granted certiorari upon the same question in *Old Mission Portland Cement Co.* v. *Helvering,* No. 107, October Term, 1934. Under the circumstances we do not oppose the granting of the writ on this question.

CONCLUSION

The decision of the court below on the question of realizing income upon the allowance of taxpayer's claim based upon a shortage of materials and supplies seems to be correct, and there is no conflict of decisions. Moreover, the question is not of general importance.

As to the question of the right of the taxpayer to deduct the amortized discount on bonds issued by an affiliated company, we do not oppose the granting of the writ in view of this Court's action in granting certiorari upon the same question in an-

other case. Therefore, the petition should be granted, limited to this question.

Respectfully submitted.

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OCTOBER 1934.

APPENDIX

Statutes and Regulations Involved

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1065:

> Sec. 213. That for the purposes of this title * * * the term "gross income"—
>
> (a) Includes gains, profits, and income derived from * * * any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period;
>
> * * * * *

Federal Control Act of March 21, 1918, c. 25, 40 Stat. 451:

> Sec. 1. That the President, having in time of war taken over the possession, use, control, and operation (called herein Federal control) of certain railroads and systems of transportation (called herein carriers), is hereby authorized to agree with and to guarantee to any such carrier making operating returns to the Interstate Commerce Commission, that during the period of such Federal control it shall receive as just compensation an annual sum, * * *.
>
> * * * * *
>
> Every such agreement shall also contain adequate and appropriate provisions for

the maintenance, repair, renewals, and depreciation of the property, for the creation of any reserves or reserve funds found necessary in connection therewith, and for such accounting and adjustments of charges and payments, both during and at the end of Federal control as may be requisite in order that the property of each carrier may be returned to it in substantially as good repair and in substantially as complete equipment as it was in at the beginning of Federal control, and also that the United States may, by deductions from the just compensations or by other proper means and charges, be reimbursed for the cost of any additions, repairs, renewals, and betterments to such property not justly chargeable to the United States; in making such accounting and adjustments, due consideration shall be given to the amounts expended or reserved by each carrier for maintenance, repairs, renewals, and depreciation during the three years ended June thirtieth, nineteen hundred and seventeen, to the condition of the property at the beginning and at the end of Federal control and to any other pertinent facts and circumstances. * * *

Transportation Act, 1920, c. 91, 41 Stat. 456, 459:

SEC. 202. The President shall, as soon as practicable after the termination of Federal control, adjust, settle, liquidate, and wind up all matters, including compensation, and all questions and disputes of whatsoever nature, arising out of or incident to Federal control.

Treasury Regulations 45 (1920 ed.), relating to the Revenue Act of 1918:

ART. 49. *Compensation for loss.*—* * * where the owner of property has lost or transferred title by reason of the exercise of

> the power of requisition or eminent domain, * * * the amount received by the owner as compensation for the property may show an excess * * * over its cost, * * *. The transaction is not regarded as completed at this stage, however, if the taxpayer proceeds immediately in good faith to replace the property, or if he makes application to establish a replacement fund as provided in the following article. * * * If the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the income shall be measured by the excess of the amount of the compensation received over the cost of the property. * * *

Treasury Regulations 65 relating to the Revenue Act of 1924:

> ART. 545. *Sale and retirement of corporate bonds.*—* * *
>
> (3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *
>
> ART. 636. *Consolidated net income of affiliated corporations.*—Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. * * *

Articles 545 and 635 of Treasury Regulations 69 relating to the Revenue Act of 1926 contain the same provisions.

U. S. GOVERNMENT PRINTING OFFICE: 1934